

# FSTP Perspectives

A publication for financial services industry  
tax and transfer pricing professionals

January 2009

## Foreword

### Dear Reader:

Welcome to the January 2009 edition of FSTP Perspectives: PwC's market leading financial services transfer pricing publication. This edition focuses on transfer pricing developments in a number of key financial services jurisdictions around the world

The financial services industry is suffering. The international banks have cumulatively written off hundreds of billions of dollars and there has been no shortage of consolidation in the financial services sector with even industry giants such as Bear Stearns, Merrill Lynch, AIG and Lehman Brothers, involved.

In spite of this financial tsunami, transfer pricing regulations, guidance and penalties have continued to multiply this year as they have in every year since the OECD published its guidelines in 1995. In Asia, for example, 2008 saw China introduce a new corporate income tax law including detailed transfer pricing provisions, a requirement for contemporaneous documentation and penalties for non-compliance. In the same year, Singapore, Malaysia, Australia and Indonesia all published circulars or legislation clarifying or expanding their approach to transfer pricing or thin capitalisation.

It would be nice to think that despite the increasing footprint of transfer pricing in Asia and around the world, tax authorities would recognise the commercial climate for financial services taxpayers and give them some leeway in pricing and documenting their intra-group transactions. That may not be the case. When tax receipts are falling, transfer pricing is a way for governments to protect their tax take without making visible and unpopular tax increases. With this in mind, it is quite possible that we will see an increase in transfer pricing

PricewaterhouseCoopers' *FSTP Perspectives* is a bi-monthly publication that offers an insight into trends and developments, tax authorities' approaches, and "hot" topic issues in financial services transfer pricing.

### Index

<b>Comment &amp; Analysis:</b> Lindy Paull: From my perspective	3
<b>OECD Releases discussion draft on the TP aspects of business restructuring:</b> Ian Dykes	5
<b>Post Deal Integration – a Transfer Pricing Challenge:</b> David McDonald and Shyamala Vyravipillai	8
<b>Expanded Definition of Low-Tax Jurisdictions Introduced in Brazil:</b> Alvaro Taiar, Mac Calva and Rita Tavares de Pina	10
<b>Application of the OECD Report on the Attribution of Profits to Permanent Establishments in Progress: The OECD Council Approves the 2008 Update to the Model Tax Convention and Releases Draft New Article 7:</b> Junko Yamato and Rita Tavares de Pina	12
<b>Dutch Supreme Court applies the arm's length principle to loans :</b> Arnout van der Rest, Marc Diepstraten, Hugo Vollebregt & Michel van der Breggen	15
<b>The Argument for Transfer Pricing Documentation in the Japanese Environment:</b> Ryann Thomas	16
<b>Sweden - Yet another inter-company interest case settled in the administrative court of appeal:</b> Pär Magnus Wiséen & Magnus Griven	19
<b>Country Focus: Singapore:</b> Paul Lau	20
<b>Country Focus: Malaysia:</b> Jagdev Singh & Lilia Adlina Azmi	23

audit activity around the world as tax authorities focus on tax collection to finance the fiscal stimulus and bailout packages that many countries are now implementing.

Another concern for taxpayers this year is that the financial crisis itself has created transfer pricing challenges that were not previously widespread. Consider four examples:

- **Losses** Tax authorities look at losses suspiciously and many openly note that losses increase the likelihood of investigation. Where losses exist, and particularly where they are concentrated in parts of a multinational group, it is important that the taxpayer address the reason that it is appropriate that they are booked there rather than in some other part of the group. Losses also pose fundamental problems in many transfer pricing mechanisms such as Profit Splits.
- **Financing** In the current climate, the price at which financing is advanced, the leverage that is attainable, the tenor of most financing and the types of financing available must be carefully monitored. Interest rates and exchange rates are volatile so timing is an even more important feature of comparability than ever before, and tax authorities are even more likely to challenge whether a transaction would have taken place at arm's length as well as challenging the interest rate charged.

- **Change** Businesses will change this year more rapidly than in recent years. The reorganisation of business units, changes in strategy, the expansion or rationalisation of overseas offices, the increasing importance of functions such as risk management and the movement of key personnel all impact the functional analysis and affect the selection of an appropriate transfer pricing methodology and the assessment of comparability.
- **Integration** The integration of organisations following a merger or acquisition raises a number of transfer pricing challenges that include dealing with inconsistent legacy policies, maximising the deductibility of integration costs and taking advantage of new planning opportunities. Post integration transfer pricing is the subject of an article in the main body of this FS TP perspectives and these issues are all considered in more detail there.

In the body of this FSTP perspectives and in subsequent editions over the new few months PwC will highlight the transfer pricing issues arising from the current financial and commercial environment that affect taxpayers in the investment management, banking and insurance sectors.

Best Regards



A handwritten signature in black ink that reads "Peter Yu".

Peter Yu



A handwritten signature in black ink that reads "David McDonald".

David McDonald

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### Lindy Paull: 'From my Perspective'



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This has been a fascinating November in Washington, D.C., and the year ahead will be equally intriguing on many fronts, including a likely shift in the direction of U.S. tax policy. This is a time filled with transition to new leadership and heightened expectation of change in federal government priorities.

By all accounts, the November 4 election was a historic victory for Democrats, giving them control of the White House and significantly increasing their majorities in both chambers of Congress. As of this writing, Democrats have gained 20 seats in the House of Representatives and seven in the Senate (five House seats and one Senate seat remain undecided). The new Congress (the 111th) will officially convene on January 3, 2009, and is expected to be in session throughout the year.

But the main focus of attention, of course, is on the new President. Senator Barack Obama (D-IL) is the first African-American to be elected President and will be sworn in as the 44th President of the United States on January 20, 2009. The excitement in anticipation of Inauguration Day is hard to capture in words and unparalleled crowds are expected to converge on Washington to witness this historic event.

Since this presidential election campaign cycle lasted nearly two years, it provided interesting insight into the operating style of the new President. Unlike many political undertakings, the Obama campaign exhibited an impressive ability to avoid missteps, stay focused on priority issues, and deliver a consistent message. Some descriptive words that come to mind are disciplined, deliberate, and decisive. In the short time since the election, President-elect Obama has operated in this manner to select his White House chief of staff, key members of his Cabinet, and an experienced team of advisors to assist with the change in power.

Suffice it to say, a disciplined and decisive operating style will serve the new President well in overcoming obstacles and advancing his agenda of change.

With the presidency and strengthened majorities in Congress, the Democrats once again will be firmly in control of the policy agenda in Washington. Although short of the 60 votes needed to prevent a filibuster in the Senate, the increased Democratic majorities may make it more difficult for Republicans to block controversial legislation, since on particular issues moderate Republicans may vote with Democrats.

Democratic policy priorities are expected to refocus attention on domestic issues and additional funding for federal programs, with less emphasis on international issues. Priority issues with a possible tax component include economic recovery, climate change, energy self-reliance, and health care reform.

The United States continues to face extraordinary fiscal and economic challenges from the continuing housing crisis, turmoil in financial markets, and volatile securities markets. Recent economic indicators on GDP growth, job losses, and consumer anxiety suggest the U.S. economy will not rebound as quickly as thought just a few months ago. Indeed, the economic downturn appears to be deepening and spreading to more sectors.

As a result, action to accelerate economic recovery is the highest priority issue by far in Washington today. Congressional leaders are actively working on economic recovery legislation with the expectation that the legislation would be passed by the new Congress and sent to the new President very early in 2009. President-elect Obama recently announced an experienced leadership team on economic, fiscal and monetary policy issues, and requested that they quickly make recommendations on ways to revitalize the economy and stimulate jobs growth. During the election campaign, President-elect Obama expressed support for a package of economic stimulus proposals, including individual tax relief, a business tax credit for new hires, increased small business expensing, increased infrastructure spending and relief to states. These

proposals are likely to be part of any economic recovery solution.

President-elect Obama's economic team will bring to the new Administration deep knowledge and experience. Timothy F. Geithner, currently the President and CEO of the Federal Reserve Bank of New York and previously held several Treasury positions, will serve as Secretary of the Treasury. Lawrence H. Summers, former Secretary of the Treasury and currently teaching at Harvard University, will serve as Director of the President's National Economic Council (NEC). Christina D. Romer, currently teaching at University of California, Berkley, will serve as Chair of the Council of Economic Advisors. Paul Volcker, former Chairman of the Federal Reserve, will chair a newly created President's Economic Recovery Advisory Board. Treasury Secretary designee Geithner and NEC Director designee Summers will be at the center of development of tax policy in the Administration.

Beyond economic stimulus, the federal tax and fiscal picture is a challenging one. At the end of 2010, the 2001 and 2003 individual tax cuts are scheduled to sunset potentially impacting more than 100 million individuals. The 10-year cost to renew these items and other expiring tax code provisions exceeds \$4 trillion. While these tax cuts are very popular and have largely been embraced by President-elect Obama, permanent renewal may be elusive, particularly when the federal budget deficit expected to rise to \$1 trillion (7 percent of GDP) for the current fiscal year.

On the business tax side, many policymakers recognize the need to reform U.S. business taxes to be competitive internationally. However, political and budget pressures are likely to impose revenue neutrality on any such effort, and in the absence of a new revenue source, the result would be that some businesses would be winners and others losers. Two key components of business tax reform are the U.S. corporate tax rate and the tax rules applicable to foreign earnings of U.S. companies.

**Corporate Tax Rate.** The U.S. rate of 39.3 percent (including state and local taxes) is the second highest among the OECD countries. In contrast, the average tax rate of the other OECD members is 26.9 percent. President-elect Obama has expressed a willingness to consider a revenue neutral reduction in the corporate tax rate.

A leading proposal to lower the corporate rate on a revenue neutral basis is H.R. 3970, introduced in October 2007 by House Ways and Means Chairman Charles E. Rangel (D-NY). The Rangel bill would lower the federal corporate rate to 30.5 percent (from 35 percent) and fully offset the cost by business tax increases. Chairman Rangel recently announced that he will reintroduce his bill to lower the federal corporate tax rate to 28 percent, but has not specified the additional revenue raisers that would be needed to make the bill revenue neutral.

Chairman Rangel is expected to continue to push his corporate rate reduction proposal in the new Congress. Of concern is the impact of his proposal to defer deduction of expenses and limit

foreign tax credits relating to deferred foreign income because it would serve to disadvantage the foreign operations of U.S. companies relative to their foreign competitors (who would continue to benefit from deferral or exemption).

**Deferral of U.S. Tax on Foreign Income.** The U.S. rules allowing deferral of U.S. tax on active foreign income continue to come under attack by certain policymakers. During his election campaign, President-elect Obama frequently noted that he would reform U.S. tax rules to address provisions that encourage companies to "ship jobs overseas" and reward companies to "retain their earnings overseas." Although he has not yet made a specific approach, it is expected that a proposal will be forthcoming.

There are several related issues that recently have gained the attention of policymakers. Of note is growing concern regarding the location of foreign operations in low tax jurisdictions and the use of transfer pricing rules to shift income to such foreign jurisdictions. This and other issues (e.g., tax havens) are likely to come under heightened scrutiny.

Given the expected interest in these issues by the new Administration, there is an increased potential for tax increases that could disadvantage foreign operations of U.S. companies.

But, for now, celebrating an historic Inauguration Day has captured the heart and soul of Washington. The change brought by a new President and new Congress will come afterward and will impact the direction of tax policy. Individual tax cuts are expected to be limited to lower and middle income groups, with tax increases on the horizon for individuals with incomes over \$250,000. The tax rate for capital gains and dividends is expected to rise to 20 percent (from 15 percent). Business tax relief is likely to be offset with business tax increases, particularly from international tax provisions. Pressure to reduce budget deficits may result in a net tax increase (particularly from business) and/or a new source of revenue at some in the future.

Stay tuned. We will keep you apprised of emerging tax developments in Washington.

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# OECD Releases discussion draft on the TP aspects of business restructuring

On the 19<sup>th</sup> September the OECD released an important set of discussion notes on transfer pricing in the context of business restructuring. Over the weekend we released our initial thoughts on the discussion notes via our 'Pricing Knowledge Network' to our clients who subscribe to our PKN News Alerts. This promises to be a very influential and potentially controversial document and here follows our initial view as contained in the PKN.

## Brief background

The Discussion Draft contains four draft issues notes including coverage of specifically internal business reorganizations designed to shift risks, intangible property and income among members of a multinational group of corporations. The four issues notes address the following subjects:

- Special consideration for risks
- Arm's length compensation for the restructuring itself
- Remuneration of post-restructuring controlled transactions
- Recognition of the actual transactions undertaken

The OECD Discussion Draft reflects the consensus views of the 30 OECD member countries on some of the most fundamental transfer pricing issues, including the treatment of cross border transfers of risks, business opportunities and business functions. It is intended to function as an interpretation of portions of the existing transfer pricing guidelines, so that it would be effective immediately upon adoption in final form and can be expected to guide competent authorities and many local tax administrations in applying transfer pricing rules to principal company structures, intellectual property migration transactions, and similar issues even before it is finalised.

Our initial reading indicates that, alongside some important and welcome clarifications and reiterations, there are several respects in which the draft significantly widens government authority to challenge business restructuring transactions under the OECD's existing Transfer Pricing Guidelines (Guidelines). The most striking of these are as follows.

The Discussion Draft seeks to create a number of exceptions to the general rule that governments should base transfer pricing analysis on the transactions and agreements as structured and adopted by the taxpayer

The discussion draft interprets Guidelines 1.26 to 1.29 in such a way as to allow for piecemeal re-characterisation of individual contract terms where substance is found to differ from form, or where the terms are not arm's length. This appears to mark a significant departure from current practice. The current commentary on Article 9 in the model treaty deals with any such discrepancies via pricing adjustments, not by adjusting contractual terms or re-characterising transactions. The issues surrounding 'substance over form' adjustments and 'non-arm's length terms' adjustments are treated in slightly different ways:

## Adjusting contractual terms where substance differs from form

The approach endorsed in more than one section of the Discussion Draft requires the use of hindsight. That is, did the parties to the agreement do what they originally contracted to do? If not, then the suggestion is to change the relevant contractual terms. This does not appear to be an arm's length remedy and the OECD have not previously endorsed the use of hindsight in this manner.

The key examples in the draft pertain to differences between the contractual allocation of risk and the manner and location in which those risks are controlled. In this respect, the draft is adopting some of the thinking found in the OECD work on attribution of income to permanent establishments that focuses on people and functions. It is clear that in the future even more careful attention will need to be given to making sure that actual practice and planned agreements correspond.

*That said, the Discussion Draft makes it clear that for most OECD members a company with real substance, including employees responsible for managing the risks*

*that company contractually assumes, should be respected for transfer pricing purposes and that its dealings should be tested under the arm's length standard.*

## Adjusting contractual terms where the original terms are not arm's length

In addition to the 'substance over form' test noted above, it is suggested that adjustments to contractual terms are to be allowed where the terms would not have been agreed by third parties in similar circumstances. This is despite the fact that the Discussion Draft reiterates that associated enterprises may engage in transactions that independent enterprises would not undertake. The Draft does not state what would be interposed if terms were found not to be arm's length (i.e. would the 'most likely arm's length term' be inferred?).

However, the draft makes it clear that companies adopting transactions or assigning risks in ways that would not be commercially sensible in unrelated party dealings may have those transactions challenged. The draft cites an example where the formal duration of an inter-company manufacturing agreement could be disregarded if the context suggested that a longer-term agreement would be more appropriate.

The ramifications of this approach are extremely wide-ranging. The position taken is that the starting point for any transfer pricing analysis is a thorough understanding of the transactions as structured by the taxpayer; that contracts can be intangible assets, the features of which drive their value; and this in turn impacts on the outcome of bargaining between the parties. In particular, the imposition of an extended contract term can give rise to a transfer which might not otherwise have occurred.

The draft draws a distinction between disregarding a complete transaction (for which the existing high hurdle is retained) and disregarding individual terms. The technical difference is not explained with any rigour and from an initial reading it is hard to understand why there should be a lower standard for piecemeal adjustments to terms.

The introduction of a mechanism to adjust contractual terms in addition to the existing mechanism allowing for adjustments to price may give rise to increased uncertainty, disagreement and, ultimately, double-taxation. In particular, it could allow countries to assert that transactions are not in the form unrelated parties would have adopted, even though risks are clearly assigned in governing contracts and the risk assumptions are carried out in practice.

## The Discussion Draft seeks to take a middle ground regarding the imposition of exit taxes on transfers of profit streams pursuant to an internal reorganization.

The discussion of the transfer pricing treatment of a reorganisation starts from the proposition that exit taxes

should be imposed at the time of a restructuring only if valuable intangible assets are in fact transferred. However, the ensuing discussion appears to take a broad view of what constitutes a valuable intangible asset for this purpose. It suggests that whether a shift in the entity entitled to recognize a future profit should give rise to current tax will turn on the specific facts, including actual and implied expectations under contracts.

However, there is enough discussion of transfers of 'profit potential' giving rise to a tax obligation to create significant concern that countries will try to use the Discussion Draft to impose exit taxes in the context of a business restructuring even in the absence of a transfer of readily discernable assets.

## The Discussion Draft seems to relegate assets into a position of secondary importance relative to functions. It is also unclear about what constitutes an asset.

In the section on risk, the management of risk is given centre stage while the equally, if not more important (asset based) financial capacity to take risk is only mentioned once.

In the section on intangible assets, the draft refers to 'unprotected intangibles which cannot be transferred because they are inherent to the local operation'. It also suggests that 'pre-restructuring' activities can 'lead a distributor to own some intangibles', but it does not state how. This is difficult to reconcile with the fundamental requirements that for assets to be recognised as such they must be capable of (amongst other things) separate legal recognition or protection and of being transferred.

If the intention is to downplay a company's financial capacity to take risk, and to allow for the imputation of assets which do not meet fundamental criteria for recognition as assets then, as with the ability to impute contractual terms, the consequence will be a significant increase in uncertainty and disagreement.

## There appears to be disagreement amongst OECD member states as to whether transactions which are commercially rational at MNC level can be disregarded at subsidiary level.

It appears that the majority of OECD member states are of the view that where a restructuring is commercially rational at MNC level then the transactions which the restructuring gives rise to should be respected - even where the restructuring might not have been in the best interests of a subsidiary on a stand-alone basis. This

would hold good even where there are also tax motives for restructuring.

A minority of jurisdictions consider that the MNC-level view should not be taken into account in applying the separate entity hypothesis, particularly where a group member has transferred 'crown jewel' assets. It appears that they wish to be able to disregard the entire restructuring and, presumably, reassert the status quo ante. Some support for this is provided in the Discussion Draft which clearly indicates that in determining whether a restructuring is conducted at arm's length, it is appropriate to consider whether each of the parties to the restructuring would have found the transaction to be economically justified.

The disagreement on this point undermines the usefulness of three welcome examples provided at the end of issues note 4. It is to be hoped that this is addressed in the consultation process.

**The concept of 'non-benchmarkable functions' which features in the issues notes issued earlier this year on the transactional profit methods is reiterated.**

Despite the presence of some helpful moderating language, there is a strong emphasis on high standards of comparability with the inference that if unique functions exist they are unlikely to be capable of being benchmarked. If adopted in this form, that increases the likelihood of the imposition of profit split by tax authorities.

**The Discussion Draft purports to analyse 'the existing transfer pricing rules (i.e. the TP Guidelines in their current form)', which implies that the interpretation in the draft could have retrospective effect.**

Our initial reading would lead us to the conclusion that the interpretation outlined in these issues notes would represent a significant shift in the 'common understanding' which is required to enable mutual agreement. This retroactive implementation is consistent with the manner in which the Article 7 report on attribution of income to permanent establishments is being implemented and is certainly intended to give governments more tools to use in challenging existing risk and function stripping business arrangements. This will no doubt be an issue on which business will wish to make representations to the OECD.

We will also feature this important transfer pricing development in panel discussions at our forthcoming Global TP Conference in Vancouver in October and in our UK TP Conference in London in November. In the meantime, if you wish for further details on the issues outlined in the PKN, please do not hesitate to contact me or a member of the TP network.

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# Post Deal Integration – a Transfer Pricing Challenge

The unprecedented economic conditions affecting the Financial Services sector this year as a result of the credit crunch has forced consolidation within the sector, resulting in a series of mergers and takeovers across the major trading regions.

It is no surprise that upheaval and reorganisation on the scale of a merger or acquisition creates transfer pricing challenges that do not exist in the day to day operations of most multinational financial services businesses. The complexity of the technical questions created is often exacerbated by uncertainty in the new organisation and the paucity of timely data which forces the transfer pricing professional to assess the issues in difficult circumstances.

## The obvious transfer pricing question

When two organisations come together in a merger or acquisition their combination raises a number of transfer pricing questions that have to be dealt with quickly. The most immediately visible concern is whether the two legacy groups have the same transfer pricing policies for dealing with their international transactions. Where they do not, the taxpayer has to consider which of the legacy policies it should adopt or whether a new policy is required.

That most merging groups do not have identical transfer pricing policies is not surprising. It is after all a cliché to say that Transfer Pricing is not an exact science. So even where two taxpayers are faced with identical transactions, their policies are unlikely to be exactly the same. At the same time, differences range from the relatively simple to the fundamental. At the simpler end of the spectrum two groups may both apply the cost plus method to reward their central accounting function but may use different mark-ups and different keys for allocating the accounting costs. At the more fundamental end of the spectrum, one group company may reward its satellite operations using a form of adjusted CUP whereas the other uses a residual profit split method. The two methods could result in significantly difficult allocations of taxable income.

## And it doesn't stop there

Even where the legacy groups' international transactions do not involve the same lines of business, their legacy transfer pricing

policies may still need to be redesigned in a number of ways for a number of different reasons. Factors that could trigger transfer pricing reanalysis include:

- a significant increase in the scale of the related party transactions,
- new uncontrolled pricing information; or
- change from a subsidiary operating structure to a branch structure (or vice versa).

Each of these factors could invalidate a transfer pricing policy for different reasons.

A substantial increase in the scale of intra-group transactions could make an existing policy administratively unwieldy and might mean that a new more practical, policy has to be designed. Alternatively, an increase in scale could mean a significant increase in the tax at stake and therefore might mean that a more sophisticated analysis is required.

The merger of two groups could mean that there are situations in which functions performed in-house by one legacy group are outsourced by the other group. The existence of new uncontrolled pricing information from such circumstances could, unsurprisingly, require a significant transfer pricing reassessment. In almost all countries, the application of a transfer pricing method based on uncontrolled transactional data is preferred and the existence of comparable uncontrolled transactional data cannot be ignored just because another transfer pricing policy is already in place.

It is also equally possible that the creation of a new group may reduce the pool of uncontrolled pricing data available. This would be the case if the two legacy organisations were transacting with each other before their integration was arranged. In such cases, the impact is less immediate as the uncontrolled pricing data can often continue to be used until it becomes outdated.

Finally, and perhaps most fundamentally, a change from a subsidiary operating structure to a branch structure (or vice versa) may require a significant transfer pricing policy redesign. Many countries apply transfer pricing

principles by analogy to intra-entity (head office – branch) transactions, but there are often material differences in the mechanics and result of a transfer pricing/profit attribution policy if capital or intangible assets are a significant part of the value chain. In intra-entity transactions, there is also an increased likelihood of domestic restrictions limiting the application of the arm's length principle. In many countries, for example in Asia, there are caps on the fees that a branch can pay its head office and mark-ups that may be applied to central service costs.

## The costs of integration - another headache

When two large financial institutions merge it is no exaggeration to say that the post transaction costs of integration can be huge. Often the IT costs alone can run to hundreds of millions of dollars and then there are also the costs of branding, human resourcing, strategy and even accounting. All of these costs add up.

With costs this large, it is no surprise that the centralisation or distribution of expenses is a transfer pricing issue that has to be addressed. It is also something that typically needs to be addressed quickly if deductions are to be maximised. Transfer pricing is only one aspect of tax policy that must be considered. Factors such as the characterisation of expenditures between revenue and capital, deductibility and VAT all also play important parts in the tax impact of the transfer pricing alternatives.

As with all centrally performed functions, there are core transfer pricing questions that have to be answered before a transfer pricing policy is designed. These questions may be more difficult to address in the case of integration costs because the policy is likely to be required quickly and because it will be more difficult to collect information/data than in steady state operations. Questions that need to be considered include:

- will the costs be capitalised in each country?
- will integration related costs be deductible in each country?
- will a charge attract VAT?
- which of the costs are shareholder costs?
- how should non-shareholder costs be shared around the group?
- how will the taxpayer demonstrate benefit of the activities in its satellite operations?
- is a service being performed and should a mark-up be added to the costs?
- will mark-ups be deductible in satellite jurisdictions?
- will indirect cost allocations be deductible in satellite jurisdictions?
- should there be a separate policy for recharges to branch/subsidiaries?
- are there foreign exchange or regulatory rules that will restrict deductibility? and

- does there need to be a service agreement in place to guarantee deductibility?

In addition to addressing these questions, the taxpayer has to consider whether there could be any implications of the adopted policy on other areas of its transfer pricing arrangements. For example, if the taxpayers' brand is owned by a Swiss based affiliate, its ability to charge will be significantly eroded if it is its London office that directs a rebranding exercise and worldwide subsidiaries share in the costs of the rebranding exercise.

## It can't all be bad news?

Mergers and acquisitions create opportunities for transfer pricing driven planning. As business models are redesigned it is sometimes possible to adopt transfer pricing policies with favourable tax implications for example when repatriating income. Furthermore, as a new organisation is created with a wider global footprint, the costs of flexing the value chain may decrease whilst the opportunities for transfer pricing planning increase.

Immediately after a merger or acquisition is also a good time to re-examine outdated policies because it is far easier to explain why those policies have been updated without creating the impression that the existing policy was incorrect. At the same time, other demands on transfer pricing resources may make this challenging.

## What is the conclusion?

Mergers and acquisitions, and the associated complications of integration costs and opportunities of transfer pricing planning, are difficult areas of transfer pricing and there is no getting around the fact that post-integration analysis will place a significant demand on an organisation's transfer pricing resources. The key point is that when a deal happens there will be transfer pricing opportunities and risks to be managed and it is crucial that a post integration transfer pricing work stream is established which is separate from, but works closely with, the business and finance post integration work streams.

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# Expanded Definition of Low-Tax Jurisdictions Introduced in Brazil

Law 11,727 of June 23, 2008, which comes into force on January 1, 2009, expands the definition of "low tax jurisdiction" (*país ou dependência com tributação favorecida*), as that term applies in the context of the Brazilian transfer pricing rules. The new legislation will particularly impact industries that typically engage in transactions with tax favorable jurisdictions, such as, the banking, asset management, and in the insurance and reinsurance industries, where entities are often located in these jurisdictions.

## Impact from a Transfer Pricing Perspective

The Brazilian transfer pricing rules came into force on January 1, 1997 and do not follow the internationally accepted arm's length principle. Rather, the rules set forth maximum price ceilings for deductible expenses on intercompany import transactions and minimum gross income floors for export transactions with related parties. Moreover, the rules do not allow the use of profit based methods and require methods to be applied on a product-by-product basis. These rules also apply to cross-border transactions with unrelated parties located in jurisdictions which do not impose taxation on income or which tax income at a maximum rate of less than 20 percent (*i.e.*, transactions with tax haven jurisdictions). Accordingly, companies with a presence in Brazil have to report to the tax authorities any transactions conducted with companies in tax havens. In other words, transfer pricing rules in Brazil apply not only to related party transactions, but also to unrelated party transactions involving low tax jurisdictions.

Before Law 11,727, the legislation only referred to countries when interpreting the concept of low tax jurisdiction. In an effort to facilitate compliance by taxpayers, on August 6, 2002, the Brazilian Internal Revenue Service ("Brazilian IRS") published a list of fifty three jurisdictions that were considered to be tax havens under the above definition. The Brazilian IRS list also includes jurisdictions, other than countries (*dependências*), in which local legislation provides for confidentiality vis-à-vis the disclosure of information regarding corporate ownership. It is worth noting that this broader interpretation by the tax authorities

did not derive from a statutory rule, but rather from an administrative pronouncement (Normative Instruction 188/2002). Law 11,727 statutorily expands the concept of tax haven jurisdiction in the context of the Brazilian transfer pricing rules. In this regard, the law now includes regions (*dependências*) -- which may include, for example, states, provinces, cities, etc. -- or economic areas within countries, as well as countries. In addition, the new legislation provides a more comprehensive definition of what constitutes a privileged fiscal regime. Accordingly, the transfer pricing rules apply to transactions carried out by Brazilian companies/individuals with any other company/individual (including unrelated parties) which operate under a fiscal regime that meets any of the following requirements:

- Does not impose taxation on income, or taxes income at a maximum rate of less than 20 percent;
- Grants tax benefits to non-residents (individuals or legal entities) without requiring substantial economic activity in the respective jurisdiction, or grants tax benefits to the extent that the non-resident does not conduct substantial economic activity in the jurisdiction;
- Does not impose taxation on earnings generated outside of the territory of the respective jurisdiction, or imposes tax on those earnings at a maximum rate of less than 20 percent; or
- Does not allow access to information relating to corporate ownership of local entities, the ownership of goods, and/or rights or information regarding economic transactions.

It is expected that the Brazilian IRS will expand the existing list of favorable tax regimes in order to incorporate jurisdictions or *dependências* that meet all or one of the above expanded criteria. There is a chance that such a list will include additional U.S. dependencies or territories.

## Potential Implications to the Financial Services Industry

### Financing Transactions with Low Tax Jurisdictions

The new legislation will particularly impact the sectors in the Financial Services Industry that rely significantly on transactions with tax favorable jurisdictions. Nevertheless, with respect to loan transactions, companies may register the loans with the Brazilian Central Bank, in which case the terms and conditions of the loan as registered with the Central Bank prevail and there will be no transfer pricing adjustments. However, interest paid on loans issued to or by a related person or a person resident in a tax favorable jurisdiction that are not registered with the Brazilian Central Bank will be deductible only to the extent that the interest rate equals the six-month LIBOR dollar rate plus 3 percent per year (adjusted to the contract's period). The actual amount of the interest paid on the loan in excess of this limitation will not be deductible for income tax and social contribution purposes.

### Transactions in the Financial Services Industry involving Low Tax Jurisdictions

In the banking industry, banks usually trade globally both client based and proprietary books. In doing this, they set up booking and trading entities around the world to take advantage of continuous trading throughout different time zones, and to have a better understanding of the information required to make an investment decision in a specific geographic region. In executing these global trading activities, it is common to observe that either the booking entity of some of the trading entities is located in what would constitute a low tax jurisdiction under the new definition. These transactions should be evaluated under the transfer pricing rules in Brazil because they may involve entities in low tax jurisdictions. Brazilian entities need to consider this when either managing or participating in a global trading activity, or when setting up a trading book with an affiliate based in a low tax jurisdiction of an unrelated bank.

In the case of the asset management industry, it is common to see funds established in low tax jurisdictions like Cayman Islands or Guernsey, among others. These funds typically appoint an entity to be the investment manager. The investment manager is the entity responsible for all the investment process related to the assets under management for the funds, and all the middle and back office functions associated with that process. There are a variety of structures observed in the industry to fulfill this mandate, but it is common to see that either the investment manager entity, or other entities sub-contracted by the investment manager (i.e., sub-advisors, administrative support entities, etc.) are located in low tax jurisdictions. When a Brazilian entity is engaged in any of these transactions with Funds, investment managers, sub-advisors, or any other related support entity that are based in a low tax jurisdiction, a transfer pricing analysis to support the payments made or received will be required.

Similarly, in the insurance and reinsurance industry, for a number of years, countries like Bermuda, which is already in the "black list", or Ireland have housed to some of the largest insurance and reinsurance operations in the world. These entities usually have a physical presence with employees performing functions in this process. Typical transactions include primary insurance, reinsurance in the form of quota shares or excess of loss contracts, program management services, modeling, data analysis and licensing, and other related consulting services. In any event, any Brazilian entity that engages in these transactions with entities domiciled in low tax jurisdictions per the new definition, regardless of the existence of any form of control between the parties, will be required to support the compliance with transfer pricing rules for these transactions.

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# Application of the OECD Report on the Attribution of Profits to Permanent Establishments in Progress: The OECD Council Approves the 2008 Update to the Model Tax Convention and Releases Draft New Article 7

## Background

On August 31, 2008, the OECD published the new condensed version of the OECD Model Tax Convention on Income and on Capital. The new version incorporates the 2008 Update to the Model Tax Convention ("2008 Update"), the contents of which were approved by the OECD Council on July 17, 2008. Further, proposed revisions to Article 7 and related commentary ("Draft New Article 7") were released in a draft form on July 8, 2008.

This article focuses on Article 7 (Business Profits Attributable to Permanent Establishments, "PEs") and the related commentary, with respect to the application of Parts I, II, III and IV of the OECD Report on the Attribution of Profits to Permanent Establishments ("the Report"). Notwithstanding, the 2008 Update also addresses changes in a number of other areas, which may relate to transfer pricing, such as:

- Revised Commentary on Article 5 (Permanent Establishment) with respect to the treatment of services;
- Revised Commentary on Article 12 (Royalties) with some clarification on the definition of royalties and an interpretation issue related to the distribution of software;
- Revised Commentary on Article 4 (Resident) with clarification of the concept of "place of effective management" with respect to new factors to be taken into consideration when applying the residence tie-breaker rule to legal persons, and the situation of dual-resident persons who are treaty non-residents under the tie-breaker rule;
- Revised Commentary on Article 15 (Income from Employment), addressing whether days of residence should be taken into account for the purposes of the computation of the 183-day rule of subparagraph 2a) of Article 15;
- A minor drafting change to paragraph 32.6 of the Commentary on Article 23A (Exemption Method) and Article 23B (Credit Method); and
- A minor updating of paragraph 12 of the Commentary Article 21 (Other Income).

While the impacts of the 2008 Update and Draft New Article 7 are yet to be seen and /or determined, the changes included in the 2008 Update are important to the extent that they may directly impact the interpretation of the existing treaties. Further,

the Draft New Article 7 may somewhat highlight the elements of the Report which cannot be implemented under the existing treaties, which were not many: this implies OECD's view that most of the concepts in the Report have already been reflected in the interpretations of the existing treaty, through the 2008 Update.

## Changes to the Existing Commentary on Article 7 (Business Profits Attributable to PE) under the 2008 Update

The revised Commentary on the current Article 7 of the Model Tax Convention follows the finalization of Parts I, II, III and IV of the Report. It seeks to take into account those aspects of the Report that do not conflict with the existing interpretation of Article 7, to provide improved certainty for the interpretation of existing treaties based on the current text of Article 7.

The main points in the revised Commentary are as follows:

- Separate entity approach: The revised Commentary directly refers to the Report (incorporating much of it by reference) for the application of the separate entity approach, under which the profits to be attributed to a PE are those which it would have realized if it had been a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions and dealings wholly independently from the rest of the enterprise. It in particular confirms the applicability of the Report's two-step approach in calculating the profits attributable to a PE.
- Profits attributable to dependent agent PE: The revised Commentary includes a new paragraph on the calculation of profits attributable to a dependent agent PE. It indicates, consistent with the Report, that the same principles used for other PEs apply to dependent agent PEs.
- Deductions: Article 7 provides that the deduction of expenses incurred in the operation of a PE should be allowed. The revised Commentary inserted a paragraph noting that this provision only determines which expenses should be attributed to the PE, and it

does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the PE since the conditions for deductibility are a matter of domestic law.

- **Interest expense:** The revised Commentary recognizes an attribution of arm's length amount of interest to a PE after attributing an appropriate amount of "free" capital. The rule suggests that where differences in the approaches accepted in the 'host' (the country where a PE resides) and 'home' (the country where its head office resides) countries, in providing double taxation relief, the home country should defer to the approach used by the host country, provided it gives rise to an arm's length result.
- **Intangible assets:** The revised Commentary preserves the paragraph on intangible assets and intangible development costs from the previous version of the Commentary, essentially without change. That language suggests that it is difficult to allocate intangible rights to a single part of an enterprise and notes that it would be appropriate to allocate the actual costs of the creation or acquisition of such intangible rights, as well as the costs subsequently incurred with respect to these intangible rights without any mark-up for profit or royalty.
- **Documentation:** The revised Commentary recognizes that accounting records and contemporaneous documentation that meet certain requirements provided in the Report constitute a useful starting point and may reduce substantially the potential for controversies. The revised Commentary encourages taxpayers to prepare such documentation.
- In comparison to the April 2007 draft, the changes made in the 2008 Update mostly relate to clarifications, such as:
  - It now also refers to Part IV of the Report which deals with PEs of enterprises carrying on insurance activities;
  - It includes a clarification that the separate entity approach as a central directive on attribution of profits to a PE does not mean that the amount on which the enterprise will be taxed in the source State will be exactly the same as the amount of income with respect to which the other state will have to provide relief pursuant to Articles 23A (Exemption Method) and 23B (Credit Method). Variations between the domestic laws of the two States concerning matters such as depreciation rules, the timing of recognition of income and restrictions on the deductibility of certain expenses will normally result in a different amount of taxable income in each State.
  - The revised Commentary also includes the observations made by several countries to the revised Commentary. Most of the observations refer to situations where domestic provisions require a specific level of "free" capital or where countries (i.e., Portugal, Germany, Japan and the United States) reserve the right to not follow or to not automatically accept the "symmetry" approach to capital attribution methods.

## Implications of the 2008 Update

As mentioned above, according to the Committee on Fiscal Affairs, the revised Commentary to the existing Article 7 envisages to provide more certainty to taxpayers with respect to the interpretation of existing treaties. However, the application of a revised version of the Commentaries by tax authorities and, in particular, by the Competent Authorities, to the interpretation of previously signed and ratified treaties is far from certain. There is a divide between an ambulatory and a static interpretation of treaties by courts and commentators from various countries. Whereas the Committee on Fiscal Affairs defends an ambulatory interpretation, subject to the "difference in substance" test (Introduction to the Model Tax Convention Paragraphs 29.1 to 29.3 and 35); certain countries, such as, the United States, have been reluctant to using versions of the Commentary that was not current at the time when the treaty was adopted as law. For instance, in Crow v. Commissioner the U.S. Tax court was of the opinion that interpretation of treaties is to give intent to the intention of the contracting parties, based on purpose, history and context. The same principle was adopted in National Westminster Bank, PLC v. U.S., where the U.S. Federal Court of Claims stated that the 2001 draft version of the Report was "ultimately irrelevant" to the subject litigation, because the document did not reflect the understandings and intent of the treaty partners at the time of ratification.

## Draft New Article 7 and Related Commentary

On July 7, 2008, OECD released Draft New Article 7 and related Commentary that fully incorporates the conclusions of the Report. The Committee on Fiscal Affairs expects that the new Article will be finalized in the next update to the Model Tax Convention, scheduled for 2010. The following changes to Article 7 were proposed:

- **Further Emphasis on Separate Legal Entity Approach and Limitation on Taxing Rights.** Similar to the 2008 Update, the Separate Legal Entity Approach was emphasized: in particular, the Draft New Article 7 refers to "the functions performed, assets used and risks assumed" by a PE and other parts of the enterprise, in line with the Report and the principles under the OECD Transfer Pricing Guidelines under Article 9.
- **Deletion of the Paragraph on Deductibility of Executive and General Administrative Expenses by a PE or the Head Office.** Under the Separate Legal Entity Approach, a deduction of an arm's length charge for dealings where a part of an enterprise would perform for the benefits of a PE is required: i.e., such deduction may not be necessarily at cost, as it

may have been indicated by the existing paragraph. The deletion of the paragraph clarifies this point.

- Deletion of the Paragraph Permitting Certain Approaches Akin to Formulary Apportionment Method. The deletion is in line with the OECD Transfer Pricing Guidelines, under which such method was concluded non-arm's length.
- Deletion of the Paragraph Relating to Consistency of Methods Year by Year. This paragraph existed for the preceding two paragraphs that were proposed to be deleted.
- Deletion of the Paragraph Permitting Non-profit Reporting for Mere Purchase Activities. Under Article 5, where an enterprise maintains a fixed place of business exclusively for the purpose of purchasing goods for an enterprise in a State, it would not constitute a PE. However, if the fixed place of business carries out other activities, it may constitute a PE. In such case, the existing paragraph would not be consistent with the Separate Legal Entity Approach and an arm's length remuneration may be needed.
- Addition of a New Paragraph Relating to Free Capital. Where the rules on the calculation of the amount of free capital that is used for determining the interest deductions is different between the 'host' country where a PE is located and the 'home' country, the rules in the host country must be accepted by the home country if the following two conditions are met: (i) the difference in capital attribution between the two countries must result from conflicting domestic law choices of capital attribution methods; and (ii) the home country must agree that the host country has used an authorized arm's length approach. Such 'agreement' may be made with or without the mutual agreement procedure.

In addition, the draft Commentary suggests certain paragraphs to be included in connection with corresponding adjustments and mutual agreement procedures in case of double taxations. Lastly, the Draft New Article 7 did not revise the paragraphs under the existing Commentary on intangibles.

The full text of the 2008 Update and of the New Article 7 and related Commentary can be found at OECD's website.

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# Dutch Supreme Court applies the arm's length principle to loans

In a decision of May 9, 2008 the Dutch Supreme Court applied the arm's length principle to an inter-company loan agreement within a domestic context. By many, this decision is regarded as a first step towards a shift in thinking of the Dutch Supreme Court when considering the tax treatment of inter-company debt funding: the arm's length principle is now explicitly to be applied to test such transactions. This would mean a departure from the "sound business" principle, whereby the legal form of a transaction was key (except in certain exceptional cases).

This shift in thinking of the Dutch Supreme Court could potentially result in an increased activity of the Dutch Tax Authorities in the area of inter-company financial transactions. Inter-company loans which are not sufficiently substantiated by robust, written loan agreements now seem particularly vulnerable in a tax audit and their arm's length nature may be challenged whilst being scrutinized by the Dutch Tax Authorities.

This article informs you about the facts and circumstances of this particular court case and how we envisage this may change the fiscal "landscape" of the treatment of inter-company loans from a Dutch transfer pricing perspective. Finally, we describe what can be done to mitigate the potential adverse outcomes of a tax audit.

## Court case of May 9, 2008

On 9 May 2008 the Dutch Supreme Court handed down judgment on a case where a loan had been made by a company to its parent which subsequently defaulted. The Court ruled that if and to the extent that a supply of funds occurs on terms and conditions for which a third party would not have assumed the credit risk, the lender was not acting in its own interests but in those of its shareholder. The Court held that in those circumstances and to that extent, a loss incurred on a loan is not a business cost and therefore does not affect the tax position of the lender.

## Consequences

The Supreme Court decision has prompted a discussion of the potential knock-on effect on the treatment of interest. The argument is that in so far as the assumption of the credit risk in relation to an inter-company loan is not at arm's length - because a third party would not have accepted the full risk - part of the loan cannot be considered to be a loan and therefore (a part of) the interest charged should be eliminated from the taxable profits of the group borrower. The same ought to apply to the interest income of the group lender, but it will be necessary to wait and see whether this will be readily accepted by the tax authorities.

We note that the above analysis and conclusion not only apply to inter-company debt, but could likewise apply to guaranteed bank loans to the extent that the bank would not have made such loans without that guarantee.

## Managing your TP position

The Supreme Court decision underlines the importance of having sufficient and robust documentation in place to substantiate inter-company financial transactions. Focus is not only on the price which is charged in relation to these transactions (e.g. the level of interest charged on an inter-company loan), but also whether the transaction itself and the other terms and conditions can be considered to be an arm's length transaction (e.g., is the amount of the loan at arm's length).

For more information on this Dutch Supreme Court case and the impact it may have on your inter-company financial transactions, please contact your local PwC transfer pricing contact person. Alternatively you can contact:

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# The Argument for Transfer Pricing Documentation in the Japanese Environment

In a perfect transfer pricing world, it seems likely that most tax directors would opt to prepare transfer pricing documentation for all transactions in all jurisdictions in which they operate. However, with the reality of budget and resource constraints, which often appear to be negatively correlated to the expansion of global operations, decisions must be made about where documentation priorities should lie. In these circumstances, distinctions are often drawn between different types of transactions and/or between different jurisdictions. In the former case, documentation will often be focused on the most material or complex of a multinational group's intercompany transactions. In the latter case, tax directors often draw the following distinctions between jurisdictions:

- Tier 1 countries – documentation as a compliance requirement.
- Tier 2 countries – documentation as an audit management tool.

As taxpayers will be aware, the legal position in Japan in relation to transfer pricing documentation is that documentation – contemporaneous or otherwise – is not formally required. There is no mention of any requirement to prepare and/or file transfer pricing documentation in the transfer pricing legislation, *Special Taxation Measures Law Articles 66-4 and 68-88* (“STML Art. 66-4 and 68-88”). Moreover, penalties in the event of a Japanese audit adjustment (transfer pricing or otherwise) follow automatically. Thus, the presence or absence of transfer pricing documentation (reasonable or not) makes no difference to the amount of penalty a taxpayer would pay if a transfer pricing assessment is made.

For this reason, Japan is typically categorised as a Tier 2 country when multinational enterprises are allocating resources to transfer pricing documentation based on jurisdictional distinctions. As a result, the two most compelling reasons for

preparing transfer pricing documentation for Japanese affiliates have historically been (i) for audit management<sup>1</sup>, and (ii) in certain circumstances, in order to properly complete Schedule 17(3) attached to a taxpayer's tax return<sup>2</sup>. While PricewaterhouseCoopers, and transfer pricing best practice, would always recommend preparation of transfer pricing documentation for these reasons alone, the reality is that neither of is always sufficiently persuasive for tax directors to consider doing so, without a formal compliance requirement.

However, this article will discuss the “documentation” implications of certain revisions to the Commissioner's Directive on the Operation of Transfer Pricing, released on October 22, 2008 (“Commissioner's Directive”). While neither an erosion of the underlying legal position in relation to documentation nor the introduction of “penalty protection”, the revisions do provide more weight to support arguments that intercompany transactions involving Japanese entities should be well documented. It may be that for some tax directors, the revised Commissioner's Directive finally moves Japan from a Tier 2 to a Tier 1 jurisdiction.

## Background to the Commissioner's Directive

The Commissioner's Directive was first issued on June 1, 2001, and since then has been expanded and revised on a regular basis until the most recent revisions were issued on October 22, 2008. The Commissioner's Directive is prepared by the National Tax Agency of Japan (“NTA”) to provide guidance to the Japanese tax

<sup>1</sup> See in particular paragraph 2-4, Commissioner's Directive, which lists the documents that may be requested by the tax examiners in the event of an examination. Sub-paragraph 2-4 (2) specifically refers to transfer pricing-related documentation. In addition, lack of transfer pricing documentation in the event of an audit may result in an effective shift of the burden of proof from the tax examiners to the taxpayer.

<sup>2</sup> Schedule 17(3) is required to be attached to a taxpayer's tax return. It provides details of the taxpayer's transactions with related parties, including the transfer pricing methodology adopted. It is often – although not always – difficult for a taxpayer to answer questions relating to methodology on Schedule 17(3) without having conducted some form of transfer pricing analysis (and thus some type of transfer pricing documentation is likely to be in existence).

authorities on the administration of the Japanese transfer pricing law, i.e., STML Art. 66-4 and 68-88. The Commissioner's Directive is not itself law, but provides a useful indication of how the Japanese tax authorities will administer the actual transfer pricing law.

In addition, as guidance to the Japanese tax authorities only, taxpayers should bear in mind that revisions to the Commissioner's Directive have immediate and retroactive effect for the entire period of the statute of limitations relating to transfer pricing (i.e., six years), as they are not considered to be a change in the underlying law.

## Case 1: Documentation of Intragroup Services

The provisions of the Commissioner's Directive relating to the treatment of intragroup services have been revised. Under new paragraph 2-9 (5), the Commissioner's Directive provides that in cases where a taxpayer fails to submit documents that describe the contents of the services provided, so that it is impossible for the tax examiners to identify the circumstances surrounding the provision of the services, the payment made by the Japanese taxpayer for those services may be treated as a non-deductible donation. As the NTA does not permit mutual agreement procedures for donation assessments, there would therefore be no double taxation relief available in cases where the tax examiners applied this rule.

Many tax directors may consider that this revision will have little practical impact on their documentation priorities. Intragroup services transactions are rarely material in amount for any single entity, and are almost always simple to understand. Thus, such transactions are often excluded from documentation projects based on the transactional distinctions described earlier, regardless of the jurisdictional requirements in relation to documentation. However, the fact that the NTA has seen fit to clarify in writing their position in relation to documentation only for intragroup services is a likely indication of increased focus on such transactions going forward. Therefore, in order to take all steps possible to ensure deductibility of payments for intragroup services by their Japanese entities, tax directors may want to consider moving such transactions up their documentation priority list.<sup>3</sup>

PricewaterhouseCoopers' recommendation for documentation of intragroup services is that it should cover the following key aspects:

- Intercompany services agreement (which it is assumed most taxpayers already have);
- Documentation of the functions performed by the service provider for each service;

<sup>3</sup> Moreover, as intragroup services transactions are often an allocation of central or regional costs amongst a number of affiliates using the same allocation factor(s), documentation of these transactions for one service recipient such as Japan (or from the perspective of the service provider) is likely to be more easily leveraged to other jurisdictions than documentation prepared for many other intercompany transactions.

- Documentation of the benefits received by the Japanese affiliate for each service;
- Analysis of the most appropriate allocation factor(s) for the costs relating to each service;
- Benchmarking to support any markup applied to the allocation of costs for each service; and
- Invoices in support of each payment made by the Japanese affiliate (which would ideally refer back to the agreement and the relevant documentation).

## Case 2: Documentation of Year-end Transfer Pricing Adjustments

Revisions have also been made to the provision dealing with the treatment of pricing adjustments. Paragraph 2-20 now provides that, if transaction prices are retroactively changed nominally for the purpose of adjusting transfer prices, the tax examiners will be required to determine whether those changes are based on reasonable grounds. As part of this analysis, the revisions provide that, if a price adjustment has been paid by a taxpayer, the tax examiners shall examine the reasons for the payment, the details of any advance agreement relating to the payment, the methodology used to calculate and process the payment, and any other aspects of the adjustment believed necessary to their determination. As with the amended provisions relating to intragroup services, if it is determined that the transfer pricing adjustments are not based on reasonable grounds, the tax examiners will consider such payments to be non-deductible donations.

From a documentation perspective, there is no specific requirement in paragraph 2-20 that taxpayers prepare either formal or informal documentation for year-end transfer pricing adjustments. However, it is difficult for a taxpayer to explain for the examiners during an audit investigation the reason for a year-end transfer pricing adjustment and the methodology used to calculate and process that adjustment without documentation. Moreover, it seems clear that evidence of an advance agreement between the parties relating to year-end transfer pricing adjustments can only really be proven by way of documentation prepared at the time the agreement was entered into. Thus, for practical purposes, documentation of some form seems unavoidable.

Consequently, although the documentation requirement for Case 2 is less clear-cut than for Case 1, PricewaterhouseCoopers recommends that, at a minimum, tax directors of multinational groups review all agreements for intercompany transactions where there is a possibility of a year-end adjustment payment by a Japanese affiliate. If the relevant intercompany agreements do not contain any adjustment mechanism,

it may be necessary to amend or add to the agreement to incorporate such provisions.

In addition, as a best practice, PricewaterhouseCoopers also recommends that tax directors consider what other documentation could be useful to support the reasons for the year-end adjustment and the methodology used to calculate and process that adjustment. This will help to demonstrate the reasonableness of the adjustment payment made, and thus will hopefully improve the chances of the deduction for that payment being sustained in the event of an audit. Other than the intercompany agreement referred to already, documentation in this category could include:

- A transfer pricing report to support the target level of profitability of the Japanese affiliate; and
- Documentation explaining the calculation to derive the adjustment amount at each year-end.

## Conclusion

As noted earlier, PricewaterhouseCoopers' view, and transfer pricing best practice, is that preparation of transfer pricing documentation is always recommended for Japanese affiliates, even without a formal compliance requirement to do so. However, for tax directors having to make difficult decisions about how to spend limited transfer pricing documentation budgets, best practice by itself is not always enough of a reason to take this approach.

The latest revisions to the Commissioner's Directive have upped the ante for tax directors in this regard, by providing that certain types of transactions – namely intragroup services payments and year-end transfer pricing adjustment payments – may now be classified as non-deductible donations if not properly documented. It therefore seems worthwhile for tax directors of multinational enterprises to take a moment to revisit the allocation of their transfer pricing budgets as far as they relate to the documenting of transactions involving their Japanese affiliates.

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# Sweden - Yet another inter-company interest case settled in the administrative court of appeal

Following the Fiskeby case, where the Swedish Tax Authority successfully adjusted a company's intra-group interest payments to the average bank lending rate (i.e. a relatively low interest rate) due to lack of proper documentation, another important case has been settled in the administrative court of appeal. In this recent case, the company was successful in defending an internal junior debt loan with an interest rate of 9.75 percentage points above the base rate of SEB. A key factor in the case was that the company already had an external senior debt obligation to SEB, to which the internal loan was subordinated.

The Tax Authority argued that the intra-company interest was too high and that an interest rate of 1.25% above the SEB base rate was an acceptable market rate (i.e. in line with the decision in the Fiskeby case). However, later in the case the Tax Authority accepted an interest of 5 percent above the SEB base rate. As defence for the applied interest rate the company presented a study indicating that the total loan obligation of the company was almost in line with what externally was viewed as a highly leveraged company and thus the junior debt loan was a high risk loan. In such circumstances typically, the only available financing was mezzanine or similar types of financing. The study showed that high risk mezzanine type financing for the period 2000 to 2005 had had nominal interest rate levels between 10 to 15 percent.

The court concluded that most facts indicated that the loan was to be considered a high risk loan and even if the study was limited in its scope, that company had demonstrated that the loan was concluded on market terms and as such did not deviate from what would have been concluded between unrelated parties.

Given the current harsh audit environment of transfer pricing issues in Sweden, this case clearly shows the importance of transfer pricing documentation in all circumstances, particular for financial transactions such as inter-company debt obligations.

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# Country focus: Singapore

Paul Lau is presenting the country focus on Singapore.



The Inland Revenue Authority of Singapore (IRAS) has recently issued a circular on transfer pricing consultation, setting out how they intend to review taxpayers' compliance with the arm's length standard. They have also provided additional guidance on Advance Pricing Arrangements. These developments, together with their participation at a regional transfer pricing conference and the release of a draft circular on loans and services, represent a step-up by the IRAS in ensuring that taxpayers observe internationally accepted transfer pricing principles when conducting business with related parties

## Introduction

The past few months have seen a flurry of activity within transfer pricing in Singapore. It began on 30 July 2008 when the IRAS issued a circular entitled Transfer Pricing Consultation. The circular sets out how the IRAS intend to conduct reviews of taxpayers' related party transactions. The IRAS followed the circular with a questionnaire that was sent to selected taxpayers, requesting details of such transactions.

On 20 October 2008, the IRAS issued another circular, Supplementary Administrative Guidance on Advance Pricing Arrangements (APA). Very broadly, the circular builds on the guidance provided in an earlier circular on the procedures for

seeking APAs and sets out certain important time limits which taxpayers should observe.

This circular was followed, on the next day, with the release of a public consultation paper on related party loans and services. The paper sets out the IRAS' views on the application of the arm's length principle to these two types of related party transactions commonly undertaken by taxpayers, on which feedback from the public is being sought.

Between issuing these circulars, the IRAS participated at the regional transfer pricing conference organised by the Tax Academy of Singapore on 17 October 2008, sharing their views on transfer pricing with practitioners from the region and representatives from the Organisation for Economic Cooperation and Development (OECD) and the Australian Taxation Office.

This article provides a high level commentary on these recent developments, and considers their impact on the financial services sector in Singapore. Details of the circulars can be found on the IRAS' website ([www.iras.gov.sg](http://www.iras.gov.sg)).

## Transfer pricing consultation

It should not come as a surprise to taxpayers that the IRAS should start to conduct transfer pricing reviews. It is after all two years since the Singapore transfer pricing guidelines were issued. In line with this expectation, the overall objective of the consultation is for the IRAS to assess the level of taxpayers' compliance with those guidelines.

The process begins with the IRAS sending a questionnaire to select taxpayers who have a significant volume of related party transactions, requesting information on the types and values of these transactions as well as the extent of documentation maintained to support the transfer pricing policies adopted. The IRAS will consider if a transfer pricing review ought to be undertaken on the basis of, among other things, the taxpayer's response. The review itself entails a visit to the taxpayer's premises, whereupon detailed information about the company's operations and

its related party transactions will need to be made available to the IRAS.

The IRAS have not stated any quantitative criteria on what they meant by significant related party transactions. Some years ago there was a requirement for taxpayers to provide certain information on related party transactions in their tax returns. The basis of disclosure was whether their sales/ purchases with related parties exceeded 25% of total sales / purchases. The IRAS has not indicated whether they are applying this criterion. We expect that taxpayers will be selected based on the quantum of related party transactions, their profit and loss profile and the responses to queries raised by the IRAS in the normal course of an assessment.

Although it has been set out as a consultative process, the review contains an element of field audit, through which the IRAS may make adjustment should they consider it appropriate. Therefore, taxpayers should keep sufficient documentation to demonstrate that their transactions with related parties are conducted at arm's length, this will help to mitigate the risk of an audit and subsequent adjustments.

## Additional guidance on APA

Drawing from their experience in dealing with APA applications, the IRAS has issued additional guidance for taxpayers seeking to enter into unilateral, bilateral or multi-lateral APAs. The circular sets out various important timelines to observe during pre-filing, the formal APA submission and review, and the period for which a roll-back may apply to bilateral or multi-lateral APA. The IRAS will not accept roll-backs for unilateral APAs, since the matter will be dealt with as part of the assessment process. They have also set out the circumstances under which they will discontinue an APA application; for example, when the taxpayer does not keep to reasonable timelines for providing information or when information is not complete.

## Related party loans and services

The draft circular on related party loans and services provides much needed guidance for taxpayers, given that these transactions are commonly undertaken among related parties. It reiterates the need to comply with the arm's length standard, but provides certain safe harbour and transitional provisions to assist taxpayers' with implementation.

It should be noted that in relation to lending, the guidance covers both loans transactions as well as inter-company credit balances arising from normal trading activities. There are, however, certain exclusions that should be welcomed by taxpayers: the IRAS will not insist on the charging of arm's length interest for loans between two Singapore companies or where the lender is not in the business of providing finance. Furthermore, taxpayers who have extended cross border loans on an interest free basis are given a two-year period (starting from 1 January 2009) to restructure the loans to reflect commercial, arm's length conditions.

The draft circular sets out certain comparability features relevant to loan pricing, including the purpose of the loan, its duration and currency, availability of security, market conditions etc, as one would normally expect for such arrangements. However, it does not discuss other areas typically related to intra-group financing, e.g. guarantees or whether the amount of debt is arm's length (although the latter might well be a thin capitalisation issue). It remains to be seen whether further guidance on these areas will be given in the future.

In practice, the IRAS has been disallowing deductions for interest expenses incurred by a person, to the extent they relate to interest free loans. They consider this approach to be a proxy to the application of the arm's length principle, and have stated that they will continue with this approach during the transitional period. It should, however, be noted that interest deductions and the application of the arm's length principle are strictly not mutually exclusive under current law, as the former is governed by separate statutory provisions and case law.

In relation to services, the draft circular provides examples of routine services and when it is appropriate to adopt a cost plus 5% mark-up basis of remuneration. Consistent with the approach adopted by some other tax authorities, it provides a list of activities for which such a basis may be applied, and formalises the current practice of the IRAS in this area. This approach essentially exempts taxpayers from having to conduct a formal study to prove the level of mark-up for the provision of a broad range of support services, although it should be noted that the safe harbour will not be available if the taxpayer provides similar services to third parties. Furthermore, taxpayers are not precluded from adopting a different mark-up if they are able to support the charge based on a benchmarking study. Finally it has been clarified that no mark-up is required on pass-through costs.

The draft also covers cost pooling in relation to the provision of services (but not development of intangibles). The approach is broadly in line with the principles articulated by the OECD, in that the participants' share of the overall costs should be proportionate to their respective expected benefits. Again, certain safe harbour provisions are introduced: payments charged to participants in such an arrangement may be made without a mark-up if the services are considered routine in nature and are not supplied to third parties, the provision of such services is not the taxpayer's principal activity (it will not be regarded as such if the costs of providing them do not exceed 15% of the total expenses of the service

provider) and there is documentation to prove the intent to share costs.

## Impact on the financial services sector

These developments will have significant impact on financial institutions. In particular, they emphasise the need for proper documentation to support related party transactions, as it forms a critical element of an audit defence (or in preventing an audit). It is also vital in an APA applications as having such documentation provides the basis for supporting the IRAS' negotiations with their counterparts and facilitates the meeting of timelines by the taxpayers.

A few initial observations could be made on the draft circular for loans and services. Naturally, financial institutions will not be able to rely on the safe harbour provisions for related party loans, as their principal activity comprises the provision of finance. Being in this business, they are expected to adopt arm's length pricing for lending to related parties. It is important for financial institutions to document the basis of pricing these transactions, to demonstrate that they are concluded on terms comparable to transacted with third parties (or explain any material difference in circumstances, e.g. in case of quasi-equity capital injection). Finance and treasury centres engaging in leading and lagging as part of their liquidity management mandate should also be aware that the circular may apply.

Given that many financial institutions in Singapore act as a regional hub, the guidance given for services is particularly relevant. Although the draft proposes the adoption of safe harbour for routine services, it merely removes the need to perform a detailed benchmarking to support the mark-up. There remains a need for them to be able to properly allocate expenses to the beneficiaries of the services, both for the provision of services and in cost pooling arrangements. In that regard, financial institutions will need to demonstrate the relationship between the costs incurred (whether by direct identification or by adoption of reasonable allocation keys) and the benefits received by the service recipients, in order for the latter to justify a deduction to their tax authorities. Financial institutions should also consider foreign withholding tax and value added tax considerations when introducing a mark-up to recharges.

Further, where a Singapore based taxpayer receives payment for services at a mark-up of more than 5%, it could be difficult to justify the application of the safe harbour when it provides similar services to related parties. The IRAS will likely insist on the higher mark-up for the services supplied from Singapore, since they have stated that the arm's length mark-up should be applied where available.

Finally, it will be useful for the IRAS to clarify the interaction of the loans and services circular with the withholding tax position stated in the 1977 press statement by the Ministry of Finance. It was stated in the press statement that no withholding tax will be imposed on management fees paid to non-resident related parties provided that they constitute a reimbursement of

expenses incurred outside Singapore. The IRAS should reconsider the past position only when such in-bound services are charged at cost, since they have expressly accepted the application of the arm's length standard for pricing cross-border transactions. Reviewing this position would be consistent with the preface of the 1977 press statement, where it was stated that the exemption is intended to apply to related party transactions that are conducted at arm's length and not with the intention of siphoning Singapore's profits.

## Conclusion

It can be concluded from the above that the IRAS is seeking to ensure that Singapore taxpayers adhere to internationally accepted transfer pricing guidelines in their related party dealings, without introducing draconian rules that needlessly escalate tax compliance costs. No doubt, this is reflective of the need for Singapore to balance the objectives of protecting its revenue base and honouring its tax treaty obligations, with that of ensuring that its attractiveness as a financial centre not being eroded by an uncompetitive tax regime.

Certain aspects of these transfer pricing guidelines will need to be clarified. Having said that, the guidance released to date, comprising the IRAS' position on the arm's length principle, the availability of APA as a dispute resolution mechanism and the safe harbour provisions for loans and services transactions contained in the draft circular, should in many ways help Singapore to achieve these goals.

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## Country Focus: Malaysia

Until recently, the Malaysian tax authorities have focused on the arm's length nature of related party transactions involving tangible and intangible property, with lesser attention paid to related party loans and other types of financial transactions. This position has since changed with an increasing focus on related party loans and other financial transactions which are not at arm's length. In some recent audits, the tax authorities have made adjustments to the interest charged on related party loans resulting in significant amount of additional tax and penalties. The 2009 Fiscal Budget announcement also introduced thin capitalization legislation (effective 1 January 2009) as part of the Malaysian tax authorities' broader focus on transfer pricing issues relating to financial transactions or assistance.

The new rules restrict interest, finance charge, losses and other expenses that are considered to be "excessive" in relation to the fixed capital of the taxpayer. This proposed legislation also covers financial assistance granted indirectly, i.e. credit guarantee to an associated person. To the extent to which the amount is considered excessive, the tax deduction would be disallowed. Although no "safe harbour" rules are mentioned in the proposed legislation, it is likely that a safe harbour ratio would be included in the formal rules.

Once a financial transaction has been identified (whether it is a loan, guarantee or other financial transactions), the following needs to be considered:

- Is the amount of financial assistance excessive in relation to the fixed capital of the company?
- What is the impact of the financial assistance, i.e. interest charge, finance charge, guarantee fee, foreign exchange loss, etc.?

- What should be the arm's length charge or treatment for such a transaction?

Given these recent developments and changes in the legislation, taxpayers in Malaysia will now have to pay increasing attention to any financial transaction with related parties. The introduction of thin capitalization rules also means that funding arrangements will need to be optimized.

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